**16 Economic Policymaking**

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The federal government is spending more money than it collects in taxes. In 2010, the budget deficit – or amount that federal expenditures exceeded revenues – was $1.3 trillion.

**What We Learned**

***1. What are the primary goals of American economic policy?*** The first goal of economic policy is to fund government services. A second goal is to encourage/discourage private sector activity. The government taxes behavior it wishes to discourage, such as smoking, and subsidizes activities it wants to promote, such as home ownership. A third goal of economic policy is to redistribute income, and a final goal is to promote economic growth by avoiding depression, minimizing the severity of recession, and controlling inflation.

***2. What are the most important sources of revenue for the federal government?*** The individual income tax is the largest source of revenue for the national government. Other sources of federal revenue include the corporate income tax and excise taxes levied on such items as gasoline, tobacco, and airplane tickets. In general, Republicans believe that high taxes undermine economic prosperity, whereas Democrats resist tax cuts because they want to ensure that the government has sufficient revenue to fund essential government services.

Social scientists identify three general types of taxes: progressive, proportional, and regressive. The federal income tax is progressive; sales and excise taxes are considered regressive. Critics of the nation's tax system offer a number of prescriptions for reform, including progressive tax systems, a flat tax, a national sales tax, or a value added tax (VAT). Critics of the flat tax, a national sales tax, and the VAT contend that they would shift the tax burden from middle- and upper-income earners to lower- and middle-income families.

***3. What is the relationship of federal deficit and the national debt to the nation’s economy and economic growth?*** Changes in budget deficits and surpluses reflect fluctuations in the health of the nation’s economy and the policy decisions of Congress and the president. The government must pay interest on publicly held debt, which in 2010 amounted to 5 percent of expenditures. Economists generally agree that deficit spending is an appropriate government response to a recession and deficit spending that finances economic growth may be acceptable as well. A debt crisis would take place if and when investors decide that the U.S. government is no longer a safe place to invest their money. Congress and the president could take steps now to head off a possible debt crisis, but they are reluctant to act because the options, increased taxes and/or spending cuts, are politically unpopular and may also slow economic growth.

***4. What are the most important spending priorities of the federal government?*** The most important spending priorities in 2010 were healthcare, Social Security, national defense, and income security. Medicare and Medicaid are by far the largest federal healthcare programs. The retirement of the baby-boom generation threatens the long-term solvency of Medicare, Medicaid, and Social Security. National defense includes funding for the Department of Defense as well as nuclear-weapons related activities of the Department of Energy. The income security category of federal government spending encompasses a variety of domestic spending programs, including unemployment insurance, federal retirement, and most welfare programs. Since the adoption of welfare reform in the late 1990s, the goal of welfare has changed from ensuring that poor people have basic necessities to moving the poor from welfare to work.

***5. How do Congress and the president make fiscal policy?*** Fiscal policy is the use of government spending and taxation for the purpose of achieving economic goals. The ground rules that Congress and the president must follow in formulating fiscal policy are that mandatory expenditures such as entitlement programs must be budgeted for, and budget agreements such as PAYGO must be followed. The OMB assists the president in preparing a budget, which is submitted to Congress at the beginning of the year. Only discretionary expenditures must be approved through the appropriations process. Spending programs must be authorized, regardless of whether they are entitlements or programs funded by discretionary spending. Congress and the president adopt tax bills through the legislative process.

***6. What is the policymaking role of the Federal Reserve System?*** The Federal Reserve System (the Fed) is the central banking system of the United States with authority to establish banking policies and influence the amount of credit available in the economy. Congress has ordered the Fed to make monetary policy with the aim of achieving two goals: full employment and price stability. The Fed moved aggressively in 2008-2009 to shore up the economy and stave off a financial crisis by lowering interest rates and by loaning money to banks and other financial institutions.

***7. How is American economic policy made?*** The most important elements of the environment for economic policymaking are public opinion, the strength of the economy, and party control of the executive and legislative branches of government. A number of political actors participate in setting the agenda for economic policymaking, including candidates for office, interest groups, and the media. Events, such as recessions and bouts with inflation, set the agenda as well. Economic policy formulation takes place in congressional committees, executive branch agencies, and the White House.

Whereas the executive and legislative branches of American national government are primarily responsible for the adoption of fiscal policy, the Fed adopts monetary policy. Political battles over economic policymaking do not always end with policy adoption but continue into the policy legitimation stage of the policy process. The implementation of economic policy involves nearly the whole of government in America, including the Federal Reserve System, executive branch agencies, and state and local governments. Both the executive and legislative branches of American government have mechanisms for evaluating economic policy.

**Tips for Success**

**Have goals:** Declare a major if you don’t have one already because students without goals seldom succeed. You can switch majors later if you change your mind.

**Key Terms**

**Ability To Pay Theory of Taxation**

the approach to government finance that holds that taxes should be based on an individual’s ability to pay

**Appropriations Process**

the procedure through which Congress legislatively allocates money for a particular purpose

**Authorization Process**

the procedure through which Congress legislatively establishes a program, defines its general purpose, devises procedures for its operation, specifies an agency to implement the program, and indicates an approximate level of funding for the program, but does not actually provide money

**Balanced Budget**

budget receipts equal budget expenditures

**Budget Deficit**

the amount by which annual budget expenditures exceed annual budget receipts

**Budget Surplus**

the sum by which annual budget receipts exceed annual budget expenditures

**Cost-of-Living Adjustment (COLA)**

a mechanism designed to regularly increase the size of a payment to compensate for the effects of inflation

**Depression**

a severe and prolonged economic slump characterized by decreased business activity and high unemployment

**Discretionary Spending**

budgetary expenditures that are not mandated by law or contract, including annual funding for education, the Coast Guard, space exploration, highway construction, defense, foreign aid, and the Federal Bureau of Investigation (FBI)

**Earmarks**

provisions that direct that funds be spent for particular purposes

**Entitlement Program**

a government program providing benefits to all persons qualified to receive them under law

**Estate Tax**

a tax levied on the value of an inheritance

**Excise Taxes**

taxes levied on the manufacture, transportation, sale, or consumption of a particular item or set of related items

**Federal Reserve System (Fed)**

the central banking system of the United States with authority to establish banking policies and influence the amount of credit available in the economy

**Fiscal Policy**

the use of government spending and taxation for the purpose of achieving economic goals

**Flat Tax**

an income tax that assesses the same percentage tax rate on all income levels

**Gross Domestic Product (GDP)**

the total value of goods and services produced by a nations economy in a year, excluding transactions with foreign countries

**Income Redistribution**

government taking items of value, especially money, from some groups of people and then giving items of value, either in cash or services, to other groups of people

**Inflation**

a decline in the purchasing power of the currency

**Interest**

money paid for the use of money

**Mandatory Spending**

budgetary expenditures that are mandated by law, including entitlements and contractual commitments made in previous years

**Means-Tested Program**

a government program that provides benefits to recipients based on their financial need

**Monetary Policy**

the control of the money supply for the purpose of achieving economic goals

**National Debt**

the accumulated indebtedness of the federal government

**PAYGO**

a pay-as-you-go budget rule that requires that any tax cut or spending increase be offset by tax increases or spending cuts elsewhere in the budget

**Privatization**

a process that involves the government contracting with private business to implement government programs

**Progressive Tax**

a levy that taxes people earning higher incomes at a higher rate than it does individuals making less money

**Proportional Tax**

a levy that taxes all persons at the same percentage rate, regardless of income

**Recession**

an economic slowdown characterized by declining economic output and rising unemployment

**Regressive Tax**

a levy whose burden falls more heavily on lower-income groups than on wealthy taxpayers

**Sales Tax**

a levy assessed on the retail sale of taxable items

**Subsidy**

a financial incentive given by government to an individual or a business interest to accomplish a public objective

**Tax Credit**

an expenditure that reduces an individual’s tax liability by the amount of the credit

**Tax Deduction**

an expenditure that can be subtracted from a taxpayer’s gross income before figuring the tax owed

**Tax Exemption**

the exclusion of some types of income from taxation

**Tax Preference**

a tax deduction or exclusion that allows individuals to pay less tax than they would otherwise

**Value Added Tax (VAT)**

a tax on the estimated market value added to a product or material at each stage of its manufacture or distribution

**Welfare Programs**

government programs that provide benefits to individuals based on their economic status

**Discussion Questions**

1. Describe the different kinds of tax systems. Which do you think is the most fair, and why?

2. What is the history of the Social Security program? Why do some observers worry about the future of the Social Security system?

3. What are the major types of public assistance programs?

4. What is the history of budget deficits in American national government? What are the arguments for and against deficit spending during a recession?

5. What is the role of the Federal Reserve System? How did the Fed respond to the financial crisis in 2008-2009?

**Interactive Activity**

**Simulation: You Are the President and Need to Get a Tax Cut Passed**

Tax policy not only affects government revenue, but the type of taxes that are enacted can also have a huge influence on how well the overall economy does. Should the rich pay higher taxes? What is the difference between a flat tax and a fair tax? Are some tax policies unconstitutional? In this activity, you will examine these and other issues as the President of the United States faced with differences in opinion as to how to shape the nation's tax system. In the process of navigating the difficult waters of tax policy, you will learn the difference between “conservative” and “liberal” approaches to tax policy, understand the importance of compromise in the process of creating tax bills in Congress, and examine different types of tax systems such as the “fair tax” and “flat tax” systems.

[View Simulation](http://media.pearsoncmg.com/long/long_longman_media_1/2008_raised/Player/sim.youarethepresidenttaxcut.html)

**“Talking About American Government” Podcasts**

Author Neal Tannahill discusses the most important concepts in this chapter

* [Recession and Government Finance](http://pearsonpodcasting.pearsoncmg.com/playlists/think-american-government-neal-tannahill/episodes/recession-and-government-finance#podcast-13)
* [Income Redistribution](http://pearsonpodcasting.pearsoncmg.com/playlists/think-american-government-neal-tannahill/episodes/income-redistribution#podcast-12)
* [The Social Safety Net and the Welfare State](http://pearsonpodcasting.pearsoncmg.com/playlists/think-american-government-neal-tannahill/episodes/social-safety-net-and-welfare-state#podcast-11)
* [Fiscal and Monetary Policy](http://pearsonpodcasting.pearsoncmg.com/playlists/think-american-government-neal-tannahill/episodes/fiscal-and-monetary-policy#podcast-10)
* [The Progressive Income Tax](http://pearsonpodcasting.pearsoncmg.com/playlists/think-american-government-neal-tannahill/episodes/progressive-income-tax#podcast-9)
* [Keynesian Economics](http://pearsonpodcasting.pearsoncmg.com/playlists/think-american-government-neal-tannahill/episodes/keynesian-economics#podcast-8)
* [Laissez-Faire Economics](http://pearsonpodcasting.pearsoncmg.com/playlists/think-american-government-neal-tannahill/episodes/laissez-faire-economics#podcast-7)
* [Tax Incidence](http://pearsonpodcasting.pearsoncmg.com/playlists/think-american-government-neal-tannahill/episodes/tax-incidence#podcast-6)
* [Healthcare Reform](http://pearsonpodcasting.pearsoncmg.com/playlists/think-american-government-neal-tannahill/episodes/healthcare-reform#podcast-1)
* [Medicaid](http://abavtooldev.pearsoncmg.com/VPStreaming/audio.php?clipID=ab_amgov_think_tennahill/ch14_medicaid.mp3)
* [SCHIP](http://abavtooldev.pearsoncmg.com/VPStreaming/audio.php?clipID=ab_amgov_think_tennahill/ch14_schip.mp3)